

# CRS Report for Congress

## Military Retirement: Background and Recent Developments

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# Military Retirement: Background and Recent Developments

## Summary

The military retirement system is a non-contributory, defined benefit system that has historically been viewed as a significant incentive in retaining a career military force. The system currently includes monthly compensation and benefits after an active or reserve military career, disability retirement for those physically unfit to continue to serve, and survivor benefits for the eligible survivors of deceased retirees. The monthly retirement annuity is adjusted annually by a Cost-of-Living Allowance (COLA) to ensure that the annuity is protected from the adverse consequences of inflation. Military retirees are also entitled to non-monetary benefits which include exchange and commissary privileges, medical care through TRICARE, and access to Morale, Welfare and Recreation facilities and programs.

The active component retirement system provides a choice between two retirement options based on career expectations and an individual's financial situation. Eligibility is based on years of active duty, generally becoming retirement eligible after completing 20 years of service. For reserve component personnel, their retirement system is based on "points" and reservists do not generally begin to receive retired pay until age 60. There is a third retirement system for those who are retired with a physical disability regardless of the amount of time they have spent on active duty. Disability retirement offers a choice between two retirement options; one based on longevity and one on the severity of the disability.

Congress grapples with constituent concerns as well as budgetary constraints when considering military retirement issues. While congressionally mandated changes to the military retirement system have been infrequent, any potential future changes are closely monitored by current and future retirees, and the veterans' service organizations who support them. Today, there are approximately 2.2 million military retirees and survivor benefit recipients, and roughly 6 million to 8 million family members, who are an articulate, vigilant, and well-educated constituent group.

It is estimated that approximately \$46 billion will be paid to military retirees in FY2008. With an approved 5.8% COLA for 2009, retirement costs will continue to increase.

The 10<sup>th</sup> Quadrennial Review of Military Compensation (QRMC) recently recommended a revision of both the active and reserve retirement systems. However, with ongoing military operations in Iraq and Afghanistan, and the recruiting and retention challenges being faced by the Services, the executive branch and the 111<sup>th</sup> Congress may be reluctant to alter the present system.

This report will be updated as necessary.

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# Military Retirement: Background and Recent Developments

## Overview

The military retirement system is a non-contributory, defined benefit system that has historically been viewed as a significant incentive in retaining a career military force. The system currently includes monthly compensation and benefits after an active or reserve military career, disability retirement for those physically unfit to continue to serve, and survivor benefits for the eligible survivors of deceased retirees. The monthly retirement annuity is adjusted annually by a Cost-of-Living Allowance (COLA) to ensure that the annuity is protected from the adverse consequences of inflation. Military retirees are also entitled to non-monetary benefits which include exchange and commissary privileges, medical care through TRICARE, and access to Morale, Welfare and Recreation facilities and programs.

The active component retirement system provides a choice between two retirement options based on career expectations and an individual's financial situation. Eligibility is based on years of active duty, active duty personnel generally becoming retirement eligible after completing 20 years of service. For reserve component personnel, their retirement system is based on "points" and reservists do not generally begin to receive retired pay until age 60. Both the active duty and reserve component retirement systems "vest" at 20 years of service. Those who separate voluntarily prior to the 20-year point generally receive no retirement benefits. However, there is a third retirement system for those who are retired with a physical disability regardless of the amount of time they have spent on active duty. Disability retirement also offers a choice between two retirement options; one based on years of service and one on the severity of the disability.

Congress grapples with constituent concerns as well as budgetary constraints in considering military retirement issues. While congressionally mandated changes to the military retirement system have been infrequent, any potential future changes are closely monitored by current and future retirees, and the veterans' service organizations who support them. Today, there are approximately 2.2 million military retirees and survivor benefit recipients,<sup>1</sup> and roughly 6 million to 8 million family members, who are an articulate, vigilant, and well-educated constituent group.

While the importance of a viable military retirement system is frequently cited by DOD officials and defense analysts, the reality is that less than 15% of enlisted

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<sup>1</sup> 1,859,677 military retirees receiving retired pay and 293,193 survivors receiving benefits as of September 30, 2007. *Fiscal Year 2007 DOD Statistical Report on the Military Retirement System*, DOD Office of the Actuary, May 2008.

personnel and 47% of officers will eventually become eligible for the retirement annuity.<sup>2</sup> Military personnel also become eligible for retirement at a relatively young age. The average enlisted member is 42 years old and has 21 years of service at retirement while the average officer is 46 years old and has 23 years of service.<sup>3</sup>

It is estimated that approximately \$46 billion will be paid to military retirees in FY2008. In the past, some have viewed this budget item as a place where substantial budgetary savings could be made. However, past modifications intended to save money have had a deleterious effect on military recruiting and retention. With ongoing military operations in Iraq and Afghanistan, neither the executive branch or Congress have recently proposed altering the present system.

As shown in **Table 1**, the number of military retirees and the cost of their retirement has increased annually over the past several years. These figures differ somewhat from those in **Table 4** due to accrual accounting. The minor differences between the two are purely technical. The section on *Military Retirement Budgeting and Costs* provides a full discussion of the accrual accounting system.

**Table 1. DOD Retired Military Personnel, Survivors<sup>4</sup> and Program Costs, FY2005-FY2008**

FY	Retirees and Total Program Cost	Retirees from an Active Duty Military Career	Disability Retirees	Reserve Retirees	Survivor Benefit Recipients
<b>FY2008</b>	2,170,812/ \$46.19 billion	1,466,706/ \$37.21 billion	85,499/ \$1.29 billion	328,664/ \$4.31 billion	289,943/ \$3.38 billion
<b>FY2007</b>	2,146,403/ \$44.44 billion	1,461,724/ \$35.89 billion	85,306/ \$1.27 billion	312,647/ \$4.00 billion	286,726/ \$3.28 billion
<b>FY2006</b>	2,116,690/ \$41.71 billion	1,452,505/ \$34.18 billion	87,232/ \$1.26 billion	293,014/ \$3.60 billion	283,939/ \$2.67 billion
<b>FY2005</b>	2,091,253/ \$39.28 billion	1,441,931/ \$32.44 billion	89,511/ \$1.26 billion	280,680/ \$3.32 billion	279,131/ \$2.26 billion

**Sources:** Department of Defense. Office of the Actuary. *DOD Statistical Report on the Military Retirement System*, May 2008. Document available at [<http://www.defenselink.mil/actuary/>].

While some posit that the military retirement system is overly generous, others argue that it is fair; especially given that repetitive tours of duty in Iraq and Afghanistan remain a likely prospect for today's active duty and reserve personnel.

<sup>2</sup> Department of Defense, *Valuation of the Military Retirement System, September 30, 2006*, Office of the Actuary, November 2007, p. 12.

<sup>3</sup> Department of Defense, *Fiscal Year 2007 DOD Statistical Report on the Military Retirement System*, Office of the Actuary, May 2008, pp. 85 and 101.

<sup>4</sup> Survivors include the spouse, children and others with an insurable interest who are entitled to death benefits from the DOD Military Retirement Fund.

As a result, they believe that now is not the time to make changes based on cost savings.

## Three Systems, Different Retired Pay Calculations

There are three separate and distinct but related retirement systems within DOD: one for active duty members, one for the Reserve Components, and one for those who become disabled and are generally unable to complete a normal 20-year military career due to their physical disability. Each of these retirement systems includes a provision for an annual Cost-of-Living Allowance (COLA) that will be discussed later.

### Active Component Retirement<sup>5</sup>

For active duty military personnel, there are three methods of calculating retired pay: the Final Basic Pay System, “High Three” and Redux. The applicable retirement calculation is based on the date when the servicemember first entered active duty and their basic pay<sup>6</sup> at the time of retirement,<sup>7</sup> and, in the case of Redux, a voluntary election regarding a \$30,000 bonus. The active and reserve component retirement systems “vest” after 20 years of service. Vesting for the disability retiree occurs at their disability retirement date and, in some cases, at the personal choice of the servicemember.

**Final Basic Pay System.** For persons who entered military service before September 8, 1980, the retired pay computation base is final monthly basic pay being received at the time of retirement multiplied by 2.5% for each full year of service and prorated by 1/12th for each complete month less than a full year.<sup>8</sup> The minimum amount of retired pay to which a member entitled under this formula is therefore 50% of the retired pay computation base (20 years of service X 2.5%). A servicemember who retires at 25 years receives 62.5% of the computation base (25 years of service X 2.5%). Historically, the maximum, reached at the 30-year mark, has been 75% of the computation base (30 years of service X 2.5%).

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<sup>5</sup> Also frequently referred to as regular nondisability retirement.

<sup>6</sup> Basic pay is the principal element of Regular Military Compensation (RMC). The other elements include the Basic Allowance for Housing (BAH), the Basic Allowance for Subsistence (BAS) and the federal tax advantage that results from BAH and BAS being non-taxable allowances. Basic pay is between 65% and 75% of RMC, depending on individual circumstances. Thus, a 20-year retiree may receive 50% of their basic pay upon retirement, but only 33% of RMC. RMC excludes all special pay and bonuses, reimbursements, educational assistance and any value associated with non-monetary benefits such as health care, commissaries and post exchanges.

<sup>7</sup> Unlike some civilian retirement plans, there is no provision in any of the military retirement systems for a lump sum withdrawal upon retirement.

<sup>8</sup> Section 1405(b), P.L. 99-348, July 1, 1986.

However, the FY2007 National Defense Authorization Act extended the previous pay table to 40 years, allowed additional longevity raises,<sup>9</sup> and provided additional retirement credit for service beyond 30 years at the rate of 2.5% per year.<sup>10</sup> As a result, a servicemember who retires with 40 years of service will qualify for 100% of their final basic pay in retirement. A servicemember with 41 years of service will retire with 102.5 % of their final basic pay (41 years of service X the 2.5% multiplier = 102.5%).

The Final BasicPay cohort that entered the military before September 8, 1980 and will have 29 years of service in 2009. They are quickly aging out of the system, and it is expected that all will be retired by 2016<sup>11</sup>.

**“High Three”.** For those who entered service on or after September 8, 1980, the computation base is the average of the highest three years (36 months) of basic pay rather than the final basic pay. Otherwise, calculations are the same as under the Final Basic Pay method.

**Redux.** Reductions in retired pay for future retirees were enacted in the Military Retirement Reform Act of 1986<sup>12</sup> (now referred to frequently as the “Redux” military retirement system) because it was thought that the pre-Redux system was too generous. The repeal of compulsory Redux in late 1999 by the FY2000 National Defense Authorization Act indicated that many in Congress believed the pre-Redux system was the appropriate way to compensate retirees.

Congress began taking notice of potential recruiting and retention problems related to Redux<sup>13</sup> in 1997, well before the executive branch addressed the issue. During the fall of 1998, the Administration announced that it supported Redux repeal. The FY2000 National Defense Authorization Act contained provisions for repealing compulsory Redux; it allows for post-August 1, 1986 entrants to retire under the pre-Redux (“High Three”) system or opt for Redux plus an immediate \$30,000 cash payment.

Personnel who first enter service *on or after* August 1, 1986 are required to select one of these two options for calculating their retired pay within 180 days of reaching 15 years of service.

**Option 1: Pre-Redux.** They can opt to have their retired pay computed in accordance with the pre-Redux formula, described above as “High Three”.

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<sup>9</sup> Section 601, P.L. 109-364, October 17, 2006.

<sup>10</sup> Section 642, P.L. 109-364, October 17, 2006.

<sup>11</sup> Department of Defense, *Valuation of the Military Retirement System, September 30, 2006*, DOD Office of the Actuary, November, 2007, p. 12.

<sup>12</sup> P.L. 99-348, July 1, 1986.

<sup>13</sup> Department of Defense, *Military Compensation Background Papers: Compensation Elements and Related Manpower Cost Items, Their Purposes and Legislative Backgrounds*, April 2005, p. 707/

**Option 2: Redux.** They can opt to have their retired pay computed in accordance with the Redux formula and receive an immediate \$30,000 cash bonus called a Career Status Bonus (which can actually be paid in several annual installments if the recipient so wishes, for tax purposes). Those who select the Career Status Bonus (CSB) must remain on active duty until they complete 20 years of service or forfeit a portion on the bonus.

**The Redux Formula.** Redux is different from the “High Three” formula in two major ways

**Under Age 62 Retirees.** First, for retirees under age 62, the retired pay multiplier will be reduced by one percent for each year of creditable service less than 30 years. Under this new formula, therefore, a 20-year retiree will receive 40% of his or her retired pay computation base upon retirement (20 years of service X 2.5% minus 10%), and a 25-year retiree will receive 57.5% of the computation base [(20 years of service X 2.5% minus 5%)]. A 30-year retiree, however, will receive 75% of the retired pay computation base [(20 years of service X 2.5% minus 0%)], the same as the “High Three” retiree. The Redux formula, therefore, is “skewed” much more sharply in favor of the longer-serving military careerist, theoretically providing an incentive to remain on active duty longer before retiring.

**Retirees 62 and Older.** Second, when a retiree reaches age 62, his or her retired pay will be recomputed based on the old formula, a straight 2.5% of the retired pay computation base for each year of service. Thus, beginning at 62, the 20-year retiree receiving 40% of the computation base for retired pay, according to the new formula, will begin receiving 50% of his or her original computation base; the 25-year retiree’s annuity will jump from 57.5% of the original computation base to 62.5%; and the 30-year retiree’s annuity, already at 75% of the original computation base under both the old and new formulas, will not change. (Note: this change is an increase in monthly retired pay, not a lump sum at age 62.)

A summary of these three retirement methods is portrayed in **Table 2:**

**Table 2. Comparison of Retirement Methods**

	<b>Final Basic Pay</b>	<b>“High Three”</b>	<b>Redux</b>
Applies to	Servicemembers entering before September 8, 1980	Servicemembers entering from September 8, 1980 through July 31, 1986 and persons entering after July 31, 1986 but opting not to accept the 15-year Career Status Bonus	Servicemembers entering after July 31, 1986 and accepting 15-year Career Status Bonus with additional 5-year service obligation
Basis of Computation	Final rate of monthly basic pay	Average monthly basic pay for the highest 36 months of basic pay	Average monthly basic pay for the highest 36 months of basic pay
Multiplier	2.5% per year of service	2.5% per year of service	2.5% per year of service less 1% for each year of service less than 30 (restored at age 62)
Cost-of-Living Adjustment	Full CPI	Full CPI	CPI less 1% with one-time catch up at age 62, then resumption of CPI less 1 %
Additional Benefit			\$30,000 Career Status Bonus payable at the 15-year anniversary with assumption of 5-year obligation to remain on active duty

**Source:** *Military Compensation Background Papers*, Department of Defense, Sixth Edition, April, 2005.

**Table 3** reflects retirees by service and by retired pay system. Those retiring under the Final Pay system will soon begin to decrease significantly since the junior member of that cohort who is still on active duty will have 29 years of service in 2009. While the numbers for High Three and Redux should continue to increase, these figures suggest that Redux is the least popular retirement system.

**Table 3. Retirees by Category and Service<sup>14</sup>**  
 (As of September 2008)

	Army	Air Force	Navy	Marine Corps	Total
Final Pay	587,677	584,452	408,502	86,546	1,667,177
High Three	56,546	60,902	58,284	11,818	187,550
Redux	1,666	2,176	4,375	558	8,775
Total	645,889	647,530	471,161	98,922	1,863,502

**Source:** *Department of Defense*.

### **Reserve Component Retirement<sup>15</sup>**

There are many similarities among the active and reserve retirement systems. First, Reserve Component members<sup>16</sup> must also complete 20 “qualifying” years of service to become eligible for retirement. Second, the reserve retirement system also accrues at the rate of 2.5% per “equivalent year” of qualifying service (explained below) at retirement eligibility. Third, the reserve retirement system uses either Final Basic Pay or the “High Three” to calculate retired pay; Redux is not an option for reservists. The primary differences between the two systems is the point system used to calculate “qualifying years”, equivalent years of service, and the age at which the retirement annuity is paid.

For retirement purposes, a year of “qualifying” service is a year in which a Reserve servicemember earns at least 50 retirement “points”. Points are awarded for a variety of reserve activities:

- One point for each day of active duty or annual training.<sup>17</sup>
- Fifteen points a year for membership in the Selected Reserve.
- One point for each inactive duty training (IDT) period.<sup>18</sup>

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<sup>14</sup> Includes Active, Reserve and Disability retirees.

<sup>15</sup> Also referred to as nonregular retirement. For additional information on reserve pay and benefits, see CRS Report RL30802, *Reserve Component Personnel Issues: Questions and Answers* by Lawrence Kapp, March 14, 2008.

<sup>16</sup> Reserve Component generally describes the six reserve components of the Department of Defense: the Army National Guard, the Army Reserve, the Navy Reserve, the Marine Corps Reserve, the Air National Guard and the Air Force Reserve.

<sup>17</sup> Annual training is a two-week period of active duty that usually results in 14 retirement points.

<sup>18</sup> A day of active duty for training represents one Unit Training Assembly (UTA). The (continued...)

- One point for each period of funeral honors duty.
- One point for every three satisfactorily completed credit hours of certain military correspondence courses.

With multiple opportunities to earn points, it is relatively easy for a reserve component member to accrue the requisite 50 points per year and thus earn a qualifying year for retirement. The maximum number of points per year, exclusive of active duty, has varied over time but is currently capped at 130 points.<sup>19</sup> When active duty points are added to this total, the reservist cannot earn more than 365 points a year. The number of points is critical in determining both the number of years of qualifying service and the number of “equivalent years of service” for retired pay calculation purposes.

A reservist may retire after completing 20 years of qualifying service; there is no minimum age. Upon retirement, the individual is normally transferred to the Retired Reserve and is entitled to a number of military benefits to include commissary and exchange privileges, access to Morale, Welfare and Recreation programs and facilities, and limited space available travel on military aircraft. Reservists in the Retired Reserve and not yet retired pay eligible (generally age 60) are referred to as a “Gray Area” retirees since they are in the Retired Reserve but not yet eligible for retired pay or retiree medical benefits. Time spent in the Retired Reserve counts for longevity purposes and ultimately results in higher retired pay. For example, a lieutenant colonel (LTC) who transitions to the Retired Reserve at age 45 will have their retired pay at age 60 calculated on the basic pay of a lieutenant colonel with an additional 15 years of longevity. The reservist will usually become eligible for retired pay at age 60<sup>20</sup> and also then becomes eligible for military medical care.

The date the reservist became a member of the armed forces determines whether their retired pay is calculated based on the Final Basic Pay or “High Three” system. Those entering before September 8, 1980 will retire under the Final Basic Pay system while those entering after September 8, 1980 will retire under the “High Three” system.

The actual calculation parallels the active duty system but requires a separate calculation for each individual. For example, a reserve component lieutenant colonel with 5000 points reverted to the Retired Reserve in 1993 after completing 20

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<sup>18</sup> (...continued)

normal drill weekend consists of 4 UTAs and therefore results in four retirement points. A year of weekend drills earns 48 UTAs/retirement points.

<sup>19</sup> Section 648, P.L. 110-181, January 28, 2008.

<sup>20</sup> Section 648 of the FY2008 National Defense Authorization Act reduced the age for receipt of retired pay by three months for each aggregate of 90 days of specified duty performed after January 28, 2008 (the date of enactment of the FY2008 NDAA). This authority was not made retroactive to September 11, 2001. The retired pay eligibility age cannot be reduced below 50 and eligibility for medical benefits remains at age 60.

qualifying years of service. In 2008, he turned 60 years of age and became eligible for retired pay. To calculate his retired pay, divide the total points by 360 to convert the points to years of equivalent service ( $5000 / 360 = 13.89$ ). Then multiply the years of service by the 2.5% multiplier ( $13.89 \times .025 = .3472$ ). Using the Final Basic Pay option, the 2008 base pay for a lieutenant colonel with 20 years of service is \$7,372.80 per month. Multiply earlier sum by the base pay ( $.3472 \times \$7,372.80$ ) to determine that the monthly retirement annuity will be \$2560 per month.

## Disability Retirement

Servicemembers determined to be unfit for continued service and who have a permanent and stable disqualifying physical condition may qualify for disability retirement, commonly referred to as a Chapter 61 retirement. Eligibility is based on having a DOD disability rating of 30% or greater and at least 6 months or more on active duty and the disability was not noted at the time of entrance on active duty.<sup>21</sup> As a result, some disability retirees are retired before becoming eligible for longevity retirement while others have completed 20 or more years of service.

A servicemember retired for disability may select one of two available options for calculating their monthly retired pay.<sup>22</sup>

1. Longevity Formula. Retired pay is computed by multiplying the years of service times 2.5% and then times the pay base (either final pay or “high three”, as appropriate).
2. Disability Formula. Retired pay is computed by multiplying the DOD disability percentage by the pay base.

The maximum retired pay calculation under either formula cannot exceed 75% of basic pay.<sup>23</sup> Retired pay computed under the disability formula is fully taxed unless the disability is the result of a combat-related injury. Retired pay under the longevity formula is taxable only to the extent that it exceeds what the individual would receive for a combat related injury under the disability formula.

## Military Retired Pay and Social Security

Military personnel do not contribute a portion of their salary to help pay for retirement benefits. However, they have paid taxes into the social security trust fund since January 1, 1957, and are entitled to full social security benefits based on their military service. Military retired pay and social security are not offset against each other; military retirees receive full social security benefits in addition to their military retired pay.

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<sup>21</sup> 10 U.S.C. 1201 (b)(3)(B). Prior to the FY2008 NDAA (Section 1641), disability retirement required at least 8 years of service or a disability that resulted from active duty or was incurred in the line of duty during war or national emergency.

<sup>22</sup> 10 U.S.C. 1401.

<sup>23</sup> 10 U.S.C. 1401.

## Retired Pay and the Cost-of-Living Allowance

Military retired pay is protected against inflation by statute (10 U.S.C. 1401a). The Military Retirement Reform Act of 1986, in conjunction with recent changes contained in the FY2000 National Defense Authorization Act, provide for COLAs as indicated below. Congress has not modified the COLA formula<sup>24</sup> since 1995, although virtually every year since 1982 some COLA modifications, always with the aim of reducing costs and hence the payments to retirees, have been at least discussed.

The most recent military retirement COLA was 2.3%, first applied to the retired pay disbursed on January 1, 2008. The next COLA has been announced at 5.8% and will be applied to the retired pay disbursed on January 1, 2009. For a discussion of proposed and actual COLA changes from FY1983 to FY2005, see CRS Report 98-223.

### COLAs for Pre-August 1, 1986 Entrants

For military personnel who first entered military service before August 1, 1986, each December a COLA equal to the percentage increase in the Consumer Price Index (CPI) between the third quarters of successive years will be applied to military retired pay for the annuities paid beginning each January 1. For example, assume that the CPI rises from 400.0 in the period July through September 2008 to 412.0 in the period July through September 2009, an increase of 12.0 points or 3.0% of 400.0. The monthly retired pay that accrues beginning December 2009, that will actually be paid to retirees on January 1, 2010, would be increased by 3.0% above that amount paid the previous month.

### COLAs for Personnel Who Entered Service On or After August 1, 1986

For those personnel who first entered military service on or after August 1, 1986, their COLAs will be calculated in accordance with either of two methods, as noted below.

**Non-Redux Recipients.** Those personnel who opt to have their retired pay computed in accordance with the pre-Redux (“High Three”) formula will have their COLAs computed as described above for pre-August 1, 1986 entrants.

**Redux/\$30,000 Cash Bonus Recipients.** Those personnel who opt to have their retired pay computed in accordance with the Redux formula, and receive the \$30,000 cash bonus, will have their COLAs computed using a different formula. Annual COLAs will be held one percentage point below the actual inflation rate.

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<sup>24</sup> The actual index used to adjust COLA is the CPI-W; the index for urban wage earners and clerical workers. It represents the buying habits of approximately 32% of the noninstitutional population of the U.S. Department of Defense, *Military Compensation Background Papers*, Sixth Edition, April, 2005.

Retirees covered by this COLA formula would thus receive a 2.0% increase (rather than 3.0%) in their military retired pay under the hypothetical example described in the preceding example for Pre-August 1, 1986 entrants. When a retiree reaches age 62, there will be a one-time recomputation of his or her annuity to make up for the lost purchasing power caused by the holding of COLAs to the inflation rate minus one percentage point. This recomputation of COLA, in combination with the recomputation of the retired pay multiplier, restores the member's retired pay to that of a similarly retired member who did not take the Bonus/REDUX option. After the recomputation at 62, however, future COLAs will continue to be computed annually on the basis of the inflation rate minus one percentage point.

## Costs and Benefits of the Two Retirement Alternatives

An analysis of the economic effects for hypothetical retirees indicates that in almost all cases opting for the pre-Redux formula will pay the individual much more over time. A report of the Center for Naval Analyses states that the more liberal retired pay computation formula and COLA formula of pre-Redux far outweighs the short-term benefits of a \$30,000 pre-tax cash bonus. The report did say that it might be possible for an individual investor to "beat" these negative aspects of the bonus by wise investment decisions but that it would be difficult.<sup>25</sup> Naturally, no study can know what an individual's financial situation is. At first, only a fairly small percentage of personnel opted for the \$30,000 lump sum.<sup>26</sup> However, the number appears to have been rising. Since the bonus option first became available in 2001, 50% of eligible Marine Corps enlisted retirees, 40% of warrant officers, but only 13% of commissioned officers have taken it,<sup>27</sup> suggesting the attractiveness of the immediate cash payment to the lower-paid members of the career force.

## Military Retirement Budgeting and Costs

### Accounting for Military Retirement in the Federal Budget

All DOD budgets through FY1984 reflected the costs of retired pay actually being paid out to personnel who had already retired. Congress simply appropriated the amount of money required to pay current retirees each year as part of each annual defense appropriations bill. Since FY1985, the "accrual accounting" concept has been used to budget for the costs of military retired pay. Under this system, the DOD budget for each fiscal year includes, not the amount of retired pay actually paid to retirees, but rather, a contribution to the military retirement fund sufficient to finance future retirement payouts to current uniformed personnel when they retire. These annual "accrual" contributions accumulate in the military retirement fund, along with

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<sup>25</sup> Crawley, Vince. "Report: Taking Redux Bonus Is 'Loan' Against Retirement." *Marine Corps Times*, May 21, 2001, p. 10.

<sup>26</sup> Crawley, Vince. "Which Pays Best ... The Bonus or the Egg?" *Army Times*, April 22, 2002, p. 14; "How the Choices Compare." *Army Times*, April 22, 2002, p. 15.

<sup>27</sup> Brinkley, C. Mark. "Skip 'Redux' Bonus, Former Top Enlisted Marine Warns: Retired-pay Cut Not Worth It, Sergeant Major Says." *Marine Corps Times*, August 2, 2004, p. 25.

interest earned on them. The amount that the Defense Department must contribute each year to cover future retirement costs is determined by an independent, Presidentially appointed, Department of Defense Retirement Board of Actuaries, which decides how much is needed to cover future retirement costs as a percentage of military basic pay. Once military personnel retire, payments to them are made, not from the annual Department of Defense budget, but from the accumulated amounts in the military retirement fund. Estimated future retirement costs are arrived at by making projections based on the past rates at which active duty military personnel stayed in the service until retirement, and on assumptions regarding the overall U.S. economy, including interest rates, inflation rates, and military pay levels. Approximately 30% of military basic pay costs must be added to the DOD personnel budget each fiscal year to cover the future retirement costs of those personnel who ultimately retire from the military.

*DOD budget authority and outlays* in each fiscal year that pay for the estimated cost of future retirees are transferred in a paper transaction to a Military Retirement Fund, located in the Income Security Function of the federal budget. The Military Retirement Fund also receives [paper] transfers from the General Fund of the Treasury to fund the initial unfunded liability of the military retirement system. This is the total future cost of military retired pay that will result from military service performed prior to the implementation of accrual accounting in FY1985. Money is disbursed from this Military Retirement Fund to current retirees. Individual retirees receive their retired pay from the Defense Finance and Accounting Service (DFAS). Technically, however, because this money paid to individuals comes not from the DOD budget, but from the Fund, it is paid out of the Income Security function of the federal budget function. Actual payments to current retirees thus show up in the federal budget as outlays from the federal budget as a whole, not from DOD. Under accrual accounting, therefore, total federal outlays for each fiscal year continue to reflect only costs of payments to military members who have already retired, as was the case before accrual accounting began. Accrual accounting only changes the manner in which the federal government accounts for military retired pay; it does not affect actual payments to individuals in any way.

## Unfunded Liability

Current debates over both federal civilian and military retirement have included some discussion of the “unfunded liability” of both. As noted above, the military retirement system’s unfunded liability consists of future retired pay costs incurred before the creation of the Military Retirement Fund in FY1985. These obligations are being liquidated by the payment to the Fund each year of an amount from the General Fund of the Treasury and will be fully paid, based on current calculations, by FY2033. The unfunded liability at the end of FY2003 was \$628.3 billion; the estimated liability for FY2004 was \$648.3 billion; for FY2005, \$666.1 billion; and for FY2006, \$684.2 billion.<sup>28</sup> These figures are between \$83 and \$92 billion higher than the estimated unfunded liability for the same years at the end of FY2003. This

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<sup>28</sup> *Valuation of the Military Retirement System, September 30, 2006*. Department of Defense Office of the Actuary, November, 2007, pp. ii, 9, 15, 25. Available online at [<http://www.dod.mil/actuary/>].

increase is due almost entirely to the enactment of concurrent receipt-related retirement benefits, since both Combat Related Special Compensation (CSRC) and Concurrent Retirement and Disability Payments (CRDP) are paid from the Military Retirement Fund but fully funded by the Treasury contribution.

Some concerns have been voiced about the amount of unfunded liability. However, (1) the hundreds of billions of dollars of unfunded liability is a cumulative amount to be paid to retirees over the next 50 years, not all at once; (2) by the time some persons first become eligible for retired pay under the pre-accrual accounting system, many others will have died; and (3) unlike the private sector, there is no way for employees to claim immediate payment of their future benefits. An analogy would be that most homeowners cannot afford to pay cash for a house, so they get a mortgage. If the mortgage had to be paid in full, almost no homeowners could afford to do so. However, spread out over 30 years, the payments are affordable. Similarly, the unfunded liability of federal retirement programs is deemed affordable when federal retirement outlays are spread over many decades.

## Military Retirement Cost Trends

Because military retirement is an entitlement, rather than a discretionary program, its costs to the *total federal budget* (payments to current retirees and survivors) have been rising modestly each year, due to a predictable slow rise in the number of retirees and survivors and cost of living increases. The cost to DOD (estimated future retirement costs of current personnel) declined after FY1989 (the beginning of the post-Cold War drawdown), as the size of the force, and therefore the number of people who will retire from it in the future, declined. As the drawdown stabilized, so did the DOD budget costs of retirement. **Table 4** indicates the costs of military retired pay in federal budget outlays (payments to current retirees) and Department of Defense accrual outlays (money set aside to fund future retirees). (As noted above, these figures differ slightly from the figures for the same fiscal years cited in **Table 1** for purely technical reasons.)

**Table 4. Military Retirement Outlays**  
(billions of current dollars)

	Military Retirement Fund Payments to Military Retirees	DOD Accrual Payments to the Military Retirement Fund
Estimated FY2008 <sup>a</sup>	\$45.5	\$14.9
Actual FY2007 <sup>a</sup>	43.5	14.4
Actual FY2006 <sup>a</sup>	41.1	13.7
Actual FY2005 <sup>b</sup>	39.0	15.0
Actual FY2004 <sup>b</sup>	37.2	14.1
Actual FY2003 <sup>c</sup>	35.6	13.7
Actual FY2002 <sup>c</sup>	35.1	12.9

- a. *FY2008 Budget of the United States Government*. Appendix, p. 937
- b. *FY2006 Budget of the United States Government*. Appendix, pp. 953-954.
- c. *FY2005 Budget of the United States Government*. Appendix, p. 927.

## Reforming the Military Retirement System

Every four years, the President is required by law<sup>29</sup> to initiate a comprehensive review of the military compensation system and to forward the review, along with his recommendations, to Congress. The most recent effort, the 10<sup>th</sup> Quadrennial Review of Military Compensation (QRMC)<sup>30</sup>, was convened in August 2005 and submitted the final portion of its report in July 2008. One of the directed areas of assessment was “the implications of changing expectations of present and potential members of the uniformed services relating to retirement.”<sup>31</sup>

A number of previous studies have noted that the military retirement system should be more flexible, equitable and efficient. To accomplish this, the QRMC suggested a major revision of both the active and reserve retirement systems highlighted by:

1. A defined benefit plan similar to the current “High Three” system but that would “vest” at 10 years of service and not be payable until age 60 for those who retired with less than 20 years of service or at age 57 for those with 20 or more years of service. Retirees could opt to receive the retirement annuity immediately upon retirement but the annuity would be reduced by 5% for each year under age 57.

2. Combined with the above defined benefit plan would be a defined contribution plan that would require the services to contribute up to 5% of annual base pay into a retirement account for each servicemember. The contribution would start at 2% for those with two years of service and increase incrementally until it reached 5% for those with five or more years of service. This plan would also vest at 10 years of service but withdrawals could not begin until age 60.

3. A system of “gate” pays would be established at specified career points to retain selected personnel in specified skill areas.

4. Separation pay would be used to encourage personnel in over manned skills to separate prior to qualifying for a normal 10 to 30 year retirement.

A somewhat unique aspect of this retirement proposal is that it would apply equally to active and reserve component members, apparently recognizing that the Reserves have transitioned from a strategic reserve to an operational force. To test the feasibility of this retirement option, the QRMC recommends a five or more year demonstration project that would use volunteers who would ultimately have the option of remaining in the demonstration or reverting to the current retirement system.

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<sup>29</sup> Section 1008(b), Title 37.

<sup>30</sup> The QRMC report on retirement can be viewed at [<http://www.defenselink.mil/news/QRMCreport.pdf>]

<sup>31</sup> Presidential memorandum, Subject: Tenth Quadrennial Review of Military Compensation, August 2, 2005.

While not stipulated, it is assumed that personnel currently in the active and reserve components would be “grandfathered” and remain eligible to retire under the current system or until the new system is thoroughly tested and evaluated for implementation.

The QRMC did not address the disability retirement system in their review.